213825

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Ex Parte No. 657

RAIL RATE CHALLENGES UNDER THE
STAND-ALONE COST METHODOLOGY

ENTERED
Office of Proceedings

APR 26 2005

Part of
Public Record

COMMENTS OF UNION PACIFIC RAILROAD COMPANY

J. MICHAEL HEMMER
LOUISE A. RINN
Union Pacific Railroad Company
1400 Douglas Street
Omaha, Nebraska 68179
Tel: (402) 544-5000

LINDA J. MORGAN
DAVID L. MEYER
MICHAEL L. ROSENTHAL
Covington & Burling
1201 Pennsylvania Ave., N.W.
Washington, D.C. 20004
Tel: (202) 662-6000
Fax: (202) 662-6291

Attorneys for Union Pacific Railroad Company

April 20, 2005

TABLE OF CONTENTS

I. APPLICATION OF THE SAC METHODOLOGY MATTERS IN THE REAL WORLD 4

II. SHORTCOMINGS IN THE APPLICATION OF THE SAC METHODOLOGY 7

A. SAC Results Conflict With Actual Experience Regarding Western Rail Rates 8

B. SAC Calculations Produce Rates That Are Disconnected From the Revenues Railroads Require to Provide Transportation Services That Shippers Demand. 10

1. Illogical Results in SAC Cases Highlight the Need for a Probing Reexamination of the SAC Methodology. 10

2. The SAC Methodology Overestimates SARR Revenues 12

a) The Current Approach to Cross-Over Traffic Leads the Board to Find Cross-Subsidies Where None Actually Exist. 12

b) The Current Approach to Revenue Projections Places the Significant Risk of Unrealistically High Projections on Railroads 16

3. The SAC Methodology Allows Shippers to Base Their Analysis on Unrealistic Assumptions About SARR Operating and Construction Costs 18

a) The current SAC methodology does not require SARRs to pay for the full measure of resources needed to provide their hypothesized service levels. 19

b) The current SAC methodology does not require SARRs to bear costs that real-world railroads cannot avoid. 21

III. SUGGESTIONS FOR FURTHER CONSIDERATION IN A FORMAL PROCEEDING 23

A. Revenue Allocation for Cross-Over Traffic 23

B. Revenue Projections 24

C. Operating and Construction Costs 25

D. Other Issues 26

IV. FUTURE PROCEEDINGS 27

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Ex Parte No. 657

RAIL RATE CHALLENGES UNDER THE
STAND-ALONE COST METHODOLOGY

COMMENTS OF UNION PACIFIC RAILROAD COMPANY

Union Pacific Railroad Company ("UP") welcomes the opportunity to participate in this public hearing on rail rate challenges under the stand-alone cost ("SAC") methodology. When the Interstate Commerce Commission ("ICC") adopted the SAC methodology as the primary test of rail rate reasonableness under the *Coal Rate Guidelines*, it recognized that "the workability of the guidelines is most appropriately evaluated in light of experience," and that experience might show "that modifications are needed to make this approach . . . fully workable." *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520, 525 (1985). In recent years, the number of cases decided using the SAC methodology has surged. With the results of most of those cases in hand, the time is now ripe to consider whether the SAC methodology is serving its intended purposes, and, if not, what changes may be necessary to advance the rail transportation policies established by Congress.

Experience shows that the SAC methodology, as currently applied, is not advancing the policy objectives established by Congress. The ICC believed that application of the SAC methodology would allow it to fulfill its twin statutory responsibilities of (i) protecting rail shippers against abusive pricing by railroads on traffic over which the railroads have market dominance, and (ii) promoting a safe and efficient rail system by allowing railroads the

opportunity to earn revenues sufficient to cover their costs. *See id.* at 521. As we discuss below, however, the SAC methodology as currently applied by the Board constrains lawful differential pricing, impedes railroads' abilities to earn adequate revenues, and thereby impairs the rail network's ability to satisfy the growing demand for rail service. We believe that, as a result of standards developed through a case-by-case accumulation of decisions, shippers can and do use the SAC methodology to suppress non-abusive, market-driven differential pricing.

In our comments below, we describe UP's concerns with the current application of the SAC methodology, and we offer some tentative suggestions for bringing SAC results into line with national transportation policy. The Board's review of the SAC methodology, however, should not begin and end with this one public hearing. The Board should step back from its case-by-case approach to rate complaints and formally reopen the *Coal Rate Guidelines* in a rulemaking that allows interested parties a full opportunity to submit evidence and offer concrete proposals for bringing rate reasonableness cases into line with the rail transportation policies set forth by Congress.

I. APPLICATION OF THE SAC METHODOLOGY MATTERS IN THE REAL WORLD

The current rail transportation environment heightens the need to reexamine the current application of the SAC methodology. Despite massive investment, the existing rail network is straining to meet growing demand. Meeting the future growth in traffic that everybody expects will require far more. Misapplied regulatory limits on rail rates both deprive railroads of the means to invest and misdirect the allocation of scarce capital resources, contrary to national transportation policy. In fact, rate regulation has reduced UP's incentive to invest in coal capacity relative to other capital needs on UP's system.

UP alone has invested nearly $6.3 billion since 1995 to sustain and improve just its coal network. *See* Ex. 1. Yet coal shippers are calling on UP to invest even more, both to

sustain existing volumes and to accommodate growth in coal traffic. UP's network is at or near capacity on several major coal segments. UP is currently moving 37 coal trains per day out of the Southern Powder River Basin ("SPRB"). In the first quarter of 2005, UP trains moved more SPRB coal than in UP's previous best-ever quarter. UP also set records for Colorado and Utah coal. UP has turned down some requests to move additional tonnage due to lack of capacity. And demand for Western coal continues to rise as existing customers increase capacity and add new units, and as Eastern plants convert to Western coal.

At the same time, growth in other commodity flows that depend on UP's rail network also requires increased line capacity, larger terminals, and additional locomotives. Because rail capacity is no longer unlimited (as it once seemed), coal traffic must compete with other traffic for available capital. Sustaining and improving the coal transportation network is a costly proposition. Coal trains weighing 19,000 gross tons wear down track and ties, pulverize ballast, and strain bridges, requiring extensive repairs and rebuilding. UP must invest its available capital with a view towards overall return on investment, as it is doing in connection with projects such as its multi-year double-tracking of the Sunset Corridor and its proposed $66 million investment to improve operations in the San Antonio, Texas, area. UP has a lengthy list of projects that will continue to compete for investment dollars with plans to improve the coal network.

Railroads already plow back far more of their revenue into investment than any other industry, including electric utilities and chemicals. They have done so in anticipation of future revenues, despite returns that the Board has judged fall short of their cost of capital. UP's cumulative revenue shortfall is $7.2 billion since the Board succeeded the ICC. *See* Ex. 2. State officials responsible for transportation planning project that infrastructure improvements, above

and beyond repair and maintenance, require Class I railroads to spend $3.5 billion annually – far beyond the $2 billion they now fund.[1] The same officials project that railroads will face a $52 billion shortfall by 2020 in the funds they need to invest in the rail network to maintain their market share relative to other transportation modes.[2] That gap must close in order for railroads to supply the transportation services that shippers require.

When it reaffirmed the rail transportation policy in the Interstate Commerce Commission Termination Act ("ICCTA"), Congress acknowledged the vital importance of financially strong railroads, able to continue infusing billions of dollars of capital into their networks. It declared that national policy was "to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail," 49 U.S.C. § 10101(1); "to promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues," *id.* § 10101(3); "to ensure the development and continuation of a sound rail transportation system," *id.* § 10101(4); and "to maintain reasonable rates" in the "absence of effective competition," but only where "rail rates provide revenues which exceed the amount necessary to maintain the rail system and to attract capital." *Id.* § 10101(6). Congress also directed the Board to make a continuing effort to assist rail carriers to attain adequate revenues. *Id.* § 10704(a)(2).

The pattern of SAC decisions since the ICCTA took effect departs from those statutory directives, in UP's view, for reasons we discuss in Part II. Of the seven SAC cases that involved Western coal, shippers won five. In four of those five shipper victories, the final SAC

---

1 *See Freight-Rail Bottom Line Report*, American Association of State Highway and Transportation Officials, p. 4.

2 *See id.*

calculation required double-digit rate reductions, ranging up to 44 percent. (The two railroad victories occurred only because complaints were dismissed due to extreme overreaching by the shippers' advisors. One involved a clear attempt to create a cross-subsidy favoring the complainant. The other involved persistent efforts to avoid the cost of building a necessary line.) The SAC methodology, as applied in these decisions, suggests that railroads are earning excessive revenues, even though they cannot afford to make investments America needs. That shows a disconnect between regulation and reality.

By restricting UP's ability to price according to market demand, the SAC methodology as currently applied presents two obstacles to meeting shipper demand for service. It deprives UP of revenue by constraining rates directly, through prescription, and indirectly, by creating litigation risks (and costs) that discourage UP from engaging in differential pricing that would fully reflect shippers' relative demand elasticities. Misapplied SAC methodology also disrupts the market signals that would otherwise tell UP where rail transportation provides the greatest value to shippers. This will drive capacity away from coal corridors as UP decides where to invest finite capital resources. Misapplication of SAC methodology thus widens the gap between actual investment and the investment required for a sound transportation system. The time is ripe for the Board to consider how it can improve the application of the SAC methodology to avoid such unfortunate results.

II. SHORTCOMINGS IN THE APPLICATION OF THE SAC METHODOLOGY

In the twenty-five years since the enactment of the Staggers Act, rail rates for transportation of Western coal have declined substantially, whether the shippers are served by only one railroad or have rail-to-rail competition, and demand for such transportation has continued to explode. That market reality is almost irreconcilable with the surge in shipper complaints and the cases finding rates excessive under the *Guidelines*. UP believes that shippers

have taken advantage of shortcomings in the current application of the SAC methodology. In particular, as discussed below, the SAC methodology consistently resolves uncertainties, inferences, and methodological weaknesses in favor of shippers in the treatment of the revenues and costs associated with constructing and operating a stand-alone railroad ("SARR"). Application of the SAC methodology thus results in regulated rates that are too low to generate the revenues rail carriers actually require to supply the transportation services that shippers demand.

A. SAC Results Conflict With Actual Experience Regarding Western Rail Rates.

The Board should regard shipper complaints about rail transportation rates for coal and the current application of the SAC methodology with skepticism. Recent applications of the SAC methodology have led to increased rate regulation despite declining rail rates for coal transportation and massive capital spending on the coal-related infrastructure to support rapid demand growth.

Over the past two decades, rail transportation of Western coal has increased dramatically, particularly for coal from the PRB. As shown in Exhibit 3, the volume of PRB coal that rail carriers transported has quadrupled since 1984, when UP and its partner entered the PRB. UP has supported this increase with massive capital investment. The investment includes major track and yard capacity expansion programs in UP's high-capacity coal corridor between the PRB mines and Gibbon, Nebraska, as well as substantial investments in the lower density lines beyond Wyoming and Nebraska that are necessary to move coal the rest of the way to individual plants.

If rail carriers were abusing their market power, one would expect to see a pattern of rising prices. In fact, the opposite has been true. As shown in Exhibit 3, rail transportation rates for coal have steadily declined since UP and its partner entered the PRB. The downward

trend of rail rates for Western coal over the past two decades has been extensively documented. *See, e.g.*, *Railroad Rates Continue Multi-Year Decline*, STB Office of Economics, Environmental Analysis, and Administration (Dec. 2000); *Railroad Regulation: Changes in Freight Railroad Rates from 1997 through 2000*, United States General Accounting Office (June 2002); *Railroad Regulation: Changes in Railroad Rates and Service Quality Since 1990*, United States General Accounting Office (Apr. 1999). This trend is not confined to coal shippers that are served by more than one railroad: exclusively served coal shippers have also seen their rail transportation rates fall. *See Railroad Rates Continue Multi-Year Decline*, p. 3 & n.3.

The number of shipper rate complaints and the results in recent cases decided under the SAC methodology are at odds with the evidence showing a market in which prices are falling and output is increasing. Of the twelve SAC cases decided since the enactment of the ICCTA, seven involved Western coal.[3] In two of those seven cases, the shippers' evidence would have supported double-digit rate reductions, but the cases were dismissed because the shippers proposed flawed SARRs. The shipper won the other five cases. Four of the five cases resulted in double-digit rate reductions – up to 44 percent – for most of the 20-year DCF period. In two of these five cases, the rate reduction to the exclusively-served coal shipper was constrained only by the 180 percent jurisdictional threshold.

This pattern of results tells us that the SAC methodology as recently applied in Western coal cases is inconsistent with railroads' need for revenues to support additional investment and their market behavior in reducing rates while expanding output over the past two decades. The pattern of results is also inconsistent with a system of rate regulation that is

---

[3] Two other cases involved grain and chemicals moving in the West.

supposed to recognize railroads' need to engage in differential pricing – that is, to charge higher prices to shippers with fewer competitive options – in order to survive and reinvest.

B. SAC Calculations Produce Rates That Are Disconnected From the Revenues Railroads Require to Provide Transportation Services That Shippers Demand.

The current application of the SAC methodology is flawed because it overestimates the current and future revenues that would be available to a SARR, and because it underestimates the costs of constructing and operating a SARR. In fact, the SAC results in one case implied that UP's coal traffic would generate more than $1 billion in excess revenues between 2000 and 2004, while, over that same period, UP sustained an actual revenue shortfall of almost $3.2 billion, as calculated by the Board's revenue adequacy methodology.

1. Illogical Results in SAC Cases Highlight the Need for a Probing Reexamination of the SAC Methodology.

The disconnect between SAC calculations and railroad revenue requirements can be difficult to appreciate if one focuses only on a specific challenged rate. But it becomes clear when one considers the broader implications of the results in a specific case. Consider, for example, the recent case with which UP is most familiar, *Wisconsin Power & Light Co. v. Union Pacific Railroad*, STB Docket No. 42051 ("*WPL*").

The *WPL* case involved PRB coal moving to Wisconsin Power & Light's Edgewater plant in Sheboygan, Wisconsin. The shipper filed a rate complaint, even though its contract rate had fallen by 25 percent over the previous decade, and even though the challenged tariff rate was lower than the expired contract rate.

The SARR in *WPL* was a coal-only railroad that handled nearly 100 percent of the PRB coal and a significant portion of Utah and Colorado coal that UP originated. More than 90 percent of the coal included in the SARR's traffic group had more than one competitive option (*e.g.*, service from a second railroad, or a barge move). Despite the prevalence of competitive

traffic, the Board concluded that UP's revenues for the entire body of traffic handled by the SARR generated a surplus of 20 to 25 percent. In other words, according to the Board's SAC analysis, UP was overcharging not only Wisconsin Power & Light, but also its other Western coal customers, the vast majority of whom had competitive options, by 20 to 25 percent.

This result defies logic and objective reality, and it is profoundly in conflict with UP's (and America's) investment needs. The SAC result in *WPL* implied that UP earned nearly $1.19 billion in excessive revenue from its coal customers between 2000 and 2004. *See* Ex. 2. But the STB found that UP was revenue inadequate in each year between 2000 and 2003; the result will undoubtedly be the same in 2004. During the period between 2000 and 2004, UP sustained an actual revenue shortfall of almost $3.2 billion, as calculated by the Board's own methodology. *See id.* The SAC results would have stripped UP of another $773 million in after-tax income. *See id.* Moreover, during the same period, UP committed more than $3.5 billion to its coal network by replacing worn-out assets and adding capacity. *See* Ex. 1. The results produced by the SAC methodology cannot be reconciled with railroads' inability to earn their cost of capital and shippers' demands for greater investment in the coal network.

The SAC results in *WPL* are also inconsistent with the concept of differential pricing, which is essential to both the theory of the *Guidelines* and the reality that railroads must be able to charge higher rates to inelastic customers in order to recover their fixed costs. But for the floor provided by the 180 percent jurisdictional threshold, UP would have been required to reduce its rates to Wisconsin Power & Light to a level just slightly above the *average* revenue per ton for Western coal movements, a figure heavily weighted by rates where there is two-railroad competition. *See Railroad Rates Continue Multi-Year Decline, supra*, p. 7. If SAC

results place captive – and thus highly inelastic – traffic at the mid-point of rate levels, meaningful differential pricing is impossible.

The Board perhaps had no occasion to consider the full implications of its analysis in *WPL* because the rate reduction ordered in that case applied only to coal moving to Edgewater. But the broader implications of that and other SAC results for both the SAC methodology and the future of railroad investment cannot be ignored. And it is *not* correct that – as the Board suggested in *Xcel Energy* – just having a SAC methodology inherently takes into account revenue adequacy.[4] The SAC methodology must be applied in a way that takes into account Congress' revenue adequacy directive. In the remainder of this Part, we discuss why the SAC methodology is not being applied in a way that respects the Board's statutory mandate to assist railroads in attaining revenues that are adequate.

2. The SAC Methodology Overestimates SARR Revenues.

Illogical results in SAC cases that curtail investment means and distort market incentives stem from flaws in the application of the SAC methodology. One flaw of the SAC methodology is that it overstates the current revenues available to the SARR and places all of the risk associated with projecting future revenues on railroads, rather than shippers.

a) The Current Approach to Cross-Over Traffic Leads the Board to Find Cross-Subsidies Where None Actually Exist.

SAC results have come to depend on revenues from cross-over traffic, as shippers have learned to take advantage of the simple, mileage-based revenue allocation assumptions that the Board has used, with minor variations, in every case since *Nevada Power*.[5] But those simple

---

[4] *Public Service Co. of Colorado d/b/a Xcel Energy v. The Burlington Northern & Santa Fe Ry.*, STB Docket No. 42057 (STB served Jan. 19, 2005) at 6.

[5] *Bituminous Coal – Hiawatha, Utah, to Moapa, Nevada*, 10 I.C.C. 259, 268 (1994).

allocations are inconsistent with SAC theory, and they have led the Board to find cross-subsidies where none actually exist.

UP recognizes that the Board's acceptance of cross-over traffic in rate cases reflects a compromise between principle and practicality in conducting a SAC analysis: the scope and complexity of rate proceedings would expand if the SARR were required to provide origin-to-destination service for all traffic grouped with the issue traffic.[6] The Board understands that this simplification comes with a price,[7] but it may not appreciate how severely a mileage-based revenue allocation undermines the SAC analysis. It also may not appreciate that the simplification is biased against the railroads (even though the shipper bears the burden of proof) and is inconsistent with the statutory duty to allow rail carriers the opportunity to earn adequate revenues.

The SAC analysis is supposed to test whether the complaint traffic cross-subsidizes other traffic. *See Guidelines*, 1 I.C.C.2d at 524. But the results produced by the analysis become meaningless when cross-over revenues are allocated between the SARR and the residual incumbent without appropriate regard for each network's relative need for contribution. Yet that is precisely what happens when cross-over revenues are allocated using a mileage-based prorate.

The fundamental problem with a mileage-based prorate is that it assigns an equal share of revenues to higher- and lower-density segments, even though higher-density segments require a lower share of the revenue from each carload of traffic moving across the segment than

---

6 *See Public Serv. Co. of Colorado d/b/a/ Xcel Energy v. The Burlington Northern & Santa Fe. Ry.*, STB Docket No. 42057 (STB served June 8, 2004) at 16.

7 *Id.*

lower-density segments in order to cover joint and common costs. Thus, when a SAC analysis allocates revenue based on mileage, higher-density segments appear to generate excess revenues, when in fact some of those revenues should have been allocated to lower-density segments in order to sustain them. In the real-world, the revenue needs of lower density lines cannot be ignored. Railroads must maintain those lines. The failure to allocate adequate revenues to lower density lines would undermine the higher density portion of the network, since the higher density lines depend on the lower density lines to gather and distribute traffic.

The revenue-allocation problem can be illustrated by reference to *WPL*. In that case, the SARR replicated UP's high-density corridor between the PRB and Chicago. It took a mileage-based share of revenues from the coal traffic moving in that corridor, much of which also used hundreds of miles of lighter-density lines not replicated by the SARR. That revenue allocation methodology, however, did not consider the relative contribution needed by the lower-density lines to sustain the cross-over traffic once it exited the SARR, and the fewer sources of contribution on those segments available to meet those needs. A more appropriate methodology would have considered that a mileage-based revenue prorate would leave inadequate contribution to sustain the off-SARR segments, requiring a reallocation of contribution from the SARR to the lower-density off-SARR segments.

As one example, the SARR in *WPL* included cross-over traffic moving from SPRB mines to Northern State Power Company's Allen S. King plant, located in Bayport, Minnesota, about 22 miles northeast of St. Paul. Between the SPRB and Gibbon Jct., Nebraska, trains moving to the King plant travel over the highest-density portion of the UP system, sharing the track, and the burden of maintaining and reinvesting in track assets, with approximately 142 trains per day between North Platte and Gibbon. Between Gibbon Jct. and Nevada, Iowa, –

another SARR segment in the WPL case – trains moving to the King plant share the track with approximately 60 to 70 trains per day. However, once those trains turn north at Nevada onto the Spine Line, they travel the remaining 246 miles to Bayport, sharing the track with only 10 trains per day between Nevada and St. Paul. Basic math drives the conclusion that each train on a 140-train or 60-train segment need contribute less towards the cost of land, grading, and other joint and common costs than each train on a 10-train segment.

UP is particularly concerned with this situation because most of its coal traffic moves at least in part over the same high-density corridor at issue in *WPL*. Until the SAC methodology is changed, UP pricing in that corridor will be critically constrained, because many shippers could construct a SARR having the same basic configuration as in *WPL*, drawing on the same revenue base and merely substituting a local delivery line for UP's Sheboygan line that served the Wisconsin Power & Light plant. Reflecting the implications of the *WPL* result, when Northern States Power decided to bring its own rate case, UP agreed to limit evidentiary submissions to issues regarding the jurisdictional threshold, because it recognized that it was highly unlikely to persuade the Board to let it charge more than that amount in light of the *WPL* precedent.

UP's concerns extend to other situations as well. As was demonstrated by the complainant's evidence in *AEPCO*,[8] shippers can use cross-over traffic from any high-density segment to create a large pool of revenues that makes it look like the defendant is overcharging for services replicated by the SARR. It can do this by short-changing the revenue needs of off-SARR segments. In *AEPCO*, the SARR consisted of little more than a carved-out portion of the

---

[8] *Arizona Electric Power Coop., Inc. v. The Burlington Northern & Santa Fe Ry.*, STB Docket No. 42058.

defendants' east-west transcontinental lines running through New Mexico and southeastern Arizona. Almost all of the SARR's traffic – about 99 percent of its total volume – was cross-over traffic, and the vast majority was exempt and highly competitive intermodal and automotive traffic. The shipper assumed that its SARR would replace the incumbents to become an overhead carrier for that cross-over traffic, taking a mileage-based prorated portion of defendants' revenues. And although the vast majority of the SARR's traffic entire traffic base was highly competitive traffic, the shipper's analysis purported to show that the defendants were overcharging their intermodal and automotive customers by up to 45 percent. The great irony in *AEPCO* was that the shipper constructed the SARR to take advantage of revenues from the same types of traffic that coal shippers often claim to be cross-subsidizing.

The Board has invited parties to offer a better approach to revenue allocation.[9] In Part III, we offer several suggestions for further consideration in a formal proceeding on how the SAC methodology might be modified to ensure that cross-over revenue allocation better reflects the relative contribution needs of SARR and the residual network and more accurately identifies actual instances of cross-subsidy.

b) The Current Approach to Revenue Projections Places the Significant Risk of Unrealistically High Projections on Railroads.

The Board has recently taken a significant step toward improving the use of revenue projections in rate cases by developing a policy that favors the application of independent, third-party forecasts created by EIA.[10] UP has never had an opportunity, however,

---

[9] *See Public Serv. Co. of Colorado d/b/a/ Xcel Energy v. The Burlington Northern & Santa Fe. Ry.*, STB Docket No. 42057 (STB served Jan. 19, 2005) at 11.

[10] *See Texas Municipal Power Agency v. The Burlington Northern & Santa Fe Ry.*, STB Docket No. 42056 (STB served Mar. 24, 2003) at 29; *Duke Energy Corp. v. Norfolk Southern Ry.* ("*Duke/NS*"), STB Docket No. 42069 (STB served Nov. 6, 2003) at 64.

to comment upon the specific EIA projections adopted by the Board, and there are reasons to believe that those projections may be biased toward overestimating the revenues generated by any particular body of SARR traffic.[11] The significant impact that revenue projections can have in rate cases makes the entire subject worthy of careful consideration in the context of a rulemaking.

The first important issue is the accuracy of revenue projections. The 20-year DCF period magnifies the cumulative effects of small variations in revenue projections. For example, in *WPL*, with just a 0.5 percent shift in the rate of increase assumed for revenues from non-issue traffic, the reduction in the tariff rate dictated by the SAC methodology would have been 9 percent smaller in year 6 of the DCF period and 17 percent smaller by year 11.

In the past, the Board has responded to railroad concerns about shippers' overly-ambitious revenue projections by asserting that the railroads could ask the Board to reopen the case if the projections prove to be incorrect. *See, e.g.*, *WPL* at 33. The Board's recent decision in *Arizona Public Service* demonstrates that a reopening cannot provide a full remedy. In that case, BNSF prevailed on its claim that the original traffic projections in the case had been too high and that the Board had set the SAC rate too low. Yet BNSF was unable to recover the difference between the rates it actually charged and the higher rates that it should have been allowed to charge. The Board held that it lacked the authority to prescribe future rates at a level that would allow BNSF to be made whole. *See Arizona Public Serv. v. The Burlington Northern & Santa Fe Ry.*, STB Docket No. 41185 (STB served Dec. 13, 2004) at 7.

---

[11] *See AEP Texas North Co. v. The Burlington Northern & Santa Fe Ry.*, STB Docket No. 41191 (Sub-No. 1), BNSF Motion to Strike at 7-11 & Murphy V.S. (Sept. 9. 2004).

The current SAC methodology creates a significant risk that railroad rates will be constrained and railroads will be harmed because of inaccurate revenue projections. Even worse, there appears to be no remedy for such errors under the Board's current approach. In Part III, we offer several suggestions for further consideration in a formal proceeding on how the SAC methodology might be modified to ensure that revenue projections are as accurate as possible and to limit the impact of projections that later prove to be incorrect.

3. The SAC Methodology Allows Shippers to Base Their Analysis on Unrealistic Assumptions About SARR Operating and Construction Costs.

Another reason for the illogical results in SAC cases is that the results too often reflect unrealistic assumptions about SARR operating and construction costs. There are two interrelated problems that the Board should consider: (a) the failure, despite the Board's longstanding (and correct) holding that a SARR must be demonstrated to be "feasible," to take into account all of the real-world costs that railroads could not avoid were they to provide the level of service posited by the SARR, and (b) a SARR's ability under the Board's precedent to avoid numerous costs and categories of costs that real-world railroads cannot avoid and must recover if they are to achieve revenue adequacy.

The SAC methodology is supposed to protect shippers not only against cross-subsidizing other traffic but also against paying for avoidable operational inefficiencies. *See Guidelines*, 1 I.C.C.2d at 524. A shipper is thus allowed to design an "optimally efficient carrier" that is "tailored to serve an identified traffic group" using the "optimum physical plant or rail system needed for that traffic." *Duke Energy Corp. v. Norfolk Southern Ry.*, STB Docket No. 42069 (STB served Nov. 6, 2003) ("*Duke/NS*") at 11-12. At the same time, however, those considerations must be balanced against the fact that the "SAC constraint is meant to serve as a practical tool, not a mere exercise in contestable market theory divorced from its purpose of

judging the reasonableness of the defendant carrier's pricing." *AEPCO* at 6-7. The current application of the SAC methodology strikes the balance at the wrong place and too often allows SARRs to avoid costs and assume efficiencies that the defendant carrier could never obtain. Consequently, even if all other elements of the SAC test were calculated correctly, the defendant would still be required to charge rates based on a cost structure that it can never achieve.

a) The current SAC methodology does not require SARRs to pay for the full measure of resources needed to provide their hypothesized service levels.

In a SAC case, the operating plan "is a crucial factor in determining both the total investment that would be needed and the annual operating costs that would be incurred by the SARR." *Carolina Power & Light Co. v. Norfolk Southern Ry.*, STB Docket No. 42072 (STB served Dec. 23, 2003) at 12. The shipper bears the burden of demonstrating that its proposed operating plan is feasible. *Id.* at 26 (citing *Guidelines*, 1 I.C.C.2d at 543). It may not generate operational efficiencies by postulating a plan that is inconsistent with real-world limitations. *See, e.g., Duke/NS* at 32. "All its data on construction and operating costs must be verifiable." *Guidelines*, 1 I.C.C.2d at 543. In practice, however, the Board's application of the SAC methodology yields outcomes that are demonstrably inconsistent with limits on achievable performance in the real world with which any railroad – actual or hypothesized – must cope.

Evidence from recent SAC cases shows the substantial gap between postulated SARR performance and the resources that real-world railroads require to achieve the same results. That is, SARRs appear to be ultra-efficient according to standard industry measures. Whether measured in terms of gross ton-miles per operating expense dollar, gross ton-miles per maintenance-of-way expense dollar, gross ton-miles per general and administrative expense dollar, or any other measure of productivity or efficiency, SARRs claim operating efficiencies far in excess of those achieved, or realistically capable of being achieved, by any Class I railroad.

One important reason for the discrepancy is that the Board's application of the SAC methodology has not demanded that complainants fully account for the types of random events that periodically affect everyday railroad operations, even when a railroad is performing at optimal service levels. These events range from massive service interruptions caused by storms and washouts to the more mundane daily delays caused when a train crew's van gets a flat tire or an animal wanders onto the tracks. In one recent week on the UP system, for example, (a) an intermodal train derailed in St. Louis, blocking that terminal; (b) one UP train struck the rear of another, blocking our coal route to Chicago for more than 24 hours; and (c) a semi-trailer fell off I-215 in California onto an intermodal train, blocking our Sunset Route. In addition, there were apparent suicides and grade crossing accidents, including a motorist who slammed into the tenth car of a UP train at almost 100 m.p.h. Incidents like these affect an entire region, and even the entire UP system, not just the trains directly involved.

Furthermore, the Board's application of the SAC methodology does not fully take into account that rail carriers provide "slack" for the inevitable delays in loading or unloading coal. For example, if frozen coal delays the release of a train, the next train and others en route must be held. Mines suffer loading problems almost every day. For example, one SPRB mine loaded little or no coal for four days last week. Problems like these consume extra crews, require sidings, and reduce locomotive utilization. All these considerations increase the assets required and the costs incurred to haul coal.

In recent cases, railroads have submitted operating evidence that was developed using established traffic models in an effort to better replicate real-world operating conditions. The Board's apparent decision to favor this kind of modeling over the discredited string diagram approach proposed by shippers is a step forward. However, in a rulemaking, we would show

that even those models dramatically underestimate the impacts of natural events, external influences, and human-factor failures on real-world train operations.

The failure to reflect accurately the unavoidable day-to-day variations in real-world railroad operations has a significant impact on calculating operating and capital costs under the SAC methodology. Real railroads deal with unavoidable variation by having some amount of redundancy built into every part of the system – crews, equipment, and facilities – that increases their costs. UP's recent service shortcomings show that when resources are stretched too thin, even small disruptions can have far-reaching effects and recovery becomes more difficult. Railroads cannot assume ideal operating conditions and an ideal allocation of resources. They cannot and do not assume that a shortage in one area can be offset by a surplus in another – they must have extra locomotives *and* extra crews, not one or the other. Even then, railroads incur delays and the resulting increased costs.

b) The current SAC methodology does not require SARRs to bear costs that real-world railroads cannot avoid.

Even if the SARRs creatively envisioned by complainants were held to realistic performance outcomes given their staffing and cost levels, or required to bear the full costs of achieving their supra-normal outcomes, they would still have important cost advantages that a defendant railroad could never replicate.

SARRs are not constrained in their ability to able to pick and choose among the traffic that they will carry; they can choose not to bear the costs of handling the most resource-intensive traffic. As a common carrier, UP lacks that luxury. SARRs can acquire 100 percent of their resources (rail, ties, etc.) at the lowest unit costs the defendant ever achieved for any purchases (or indeed sometimes at levels merely hypothesized by a paper bid letter), even though UP cannot. They can avoid the added costs associated with labor agreements that are subject to

mandatory renewal and renegotiation under the Railway Labor Act. They can avoid contending with heritage liability issues (for past use of asbestos, etc.). In short, SARRs are unburdened by many costs that real-world railroads legally must bear and must find a way to cover, lest they be driven into bankruptcy. A rate reasonableness standard should accommodate a rail carrier's need to recover such costs. Otherwise, the real railroad's investments will be constrained.

In sum, the current SAC methodology understates the actual costs of providing rail services and tests actual railroad rates based on operating plans and cost structures that real-world railroads could never replicate. It produces results that are "divorced from its purpose of judging the reasonableness of the defendant carrier's pricing." *AEPCO*, at 6-7. The Board should consider whether changes to the current SAC methodology are necessary in order to bridge or fill the gap between the rates that a SARR could charge under the assumptions behind the current SAC methodology, and the rates that a real-world railroad must charge in order to cover costs that it cannot realistically avoid. In Part III, we offer several suggestions for further consideration in a formal proceeding on how the SAC methodology might be modified to bring SARR costs more into line with costs that real-world railroads necessarily incur to handle the issue traffic.

* * *

UP believes that experience under the current SAC methodology has shown "that modifications are needed to make this approach . . . fully workable." *Guidelines*, 1 I.C.C.2d at 525. The SAC methodology overstates SARR revenues and understates SARR costs, and thus it has too often found rates to be unlawful when they actually reflect nothing more than a carrier's effort to earn adequate revenues by lawfully charging higher rates to shippers that are more dependent on rail service.

III. SUGGESTIONS FOR FURTHER CONSIDERATION IN A FORMAL PROCEEDING

UP applauds the Board's initiative in holding a public hearing to allow interested parties to express their views on the Board's consideration of cases under the SAC methodology. This hearing is an appropriate first step in a process that should culminate in revisions to the methodology that will bring it more closely in line with the policies expressed by Congress.

We recognize that re-evaluation of the SAC methodology is no simple matter. Many statutory and practical interests must be accommodated, and there are few easy answers. However, experience has highlighted some basic principles that should be reflected in a revised SAC methodology. We briefly set forth those principles below, and we look forward to a more thorough debate about how these principles can be applied as part of a formal rulemaking to reopen and modify the *Coal Rate Guidelines*.

A. Revenue Allocation for Cross-Over Traffic.

As discussed above, mileage-based methods of allocating revenues from cross-over traffic tend to overstate the revenues available to the SARR. This issue has been raised in several recent rate cases, but case-by-case adjudication has not yielded an improved allocation methodology.[12] The topic is well-suited to a rulemaking, in which solutions can evolve through the exchange of ideas rather than strict requirements of pleading and proof.

If the Board continues to allow shippers to incorporate cross-over traffic in their SARRs, UP believes that the SAC methodology should adhere to the basic principle that both the SARR and the residual incumbent are entitled to recover the attributable costs of handling cross-

---

[12] The Board's recent adoption of a "Modified Straight-Mileage Prorate" eliminates the incentives that had existed to configure a SARR artificially to take advantage of the "lumpy" nature of revenue allocation under the prior "Block Methodology." *See Duke/NS* at 23-24. However, it does not address the fundamental issues raised by use of a mileage-based prorate.

over traffic on their own systems, and that their relative needs for contribution should determine the division of any revenues above attributable costs. This principle ensures that, at a minimum, the SARR can benefit from economies of density, and the residual incumbent is not subsidizing the SARR.

We recognize that it may be easier to express this principle than to apply it. In a rulemaking, however, parties would have a full and fair opportunity to discuss, with the benefit of expert testimony, both (a) whether that principle is correct and (b) how it could be practically implemented – that is, how one could calculate attributable costs and relative need for contribution, and whether there would be appropriate assumptions, presumptions, or allocations of the burden of proof that would simplify the process.

B. Revenue Projections.

Two key revenue projection issues should be explored further: (1) how best to forecast future SARR revenue levels and (2) how to deal with the inherent potential that real-world results will underperform those estimates to the carrier's disadvantage.

On the first issue, UP agrees with the principle adopted by the Board that revenue projections developed by disinterested third-parties should be favored. The methodology and accuracy of any such projections should be scrutinized, however, before the projections are used in a rate case.[13] A third-party's neutrality is no guarantee that its methodology yields forecasts that achieve the objective of forecasting the expected revenues from a particular body of SARR traffic. Nor is neutrality a guarantee that there are not other, more accurate projections available

---

[13] As noted above, there have been questions whether EIA's projections address the issues that are relevant in a rate case. *See supra*, pp. 16-17.

from other disinterested parties. A rulemaking would allow interested parties to address EIA's methodology and accuracy and propose alternative sources of forecast data if appropriate.

Second, no matter how good forecasts are, real-world experience can diverge significantly over a 20-year DCF period, as the *Arizona Public Service* case demonstrated. A rulemaking would also allow interested parties and the Board to explore how best to reduce the adverse impact of forecasting error. Despite the perils associated with long-range revenue projections, under the current SAC methodology the Board can do little or nothing to remedy the past effects of projections that are subsequently proven wrong. In a rulemaking, parties could explore the potential benefits of reducing reliance on projections by using a shorter DCF period. They could also explore procedural options for addressing these issues, such as a simplified process for reopening decisions to correct erroneous projections before the effects accumulate.

C. Operating and Construction Costs.

UP believes that the SAC methodology should focus more closely on "judging the reasonableness of the defendant carrier's pricing." *AEPCO* at 7. Just as "a defendant carrier's ability to recover reasonable costs and earn adequate revenues should not be limited by the inclusion in [the] rate reasonableness analysis of another carrier's traffic and revenues that do not and could not reasonably be expected to pay for a defendant carrier's costs," *id.*, a defendant carrier's ability to recover costs and earn adequate revenues should not be limited by rules or practices that allow a SARR to incorporate hypothetical cost savings that would not reasonably be available to the defendant carrier. A rulemaking would provide an opportunity to discuss ways in which to bring SARR costs more in line with defendant's real-world costs.

For example, we believe that, in developing SARR operating statistics, the Board should favor the use of real-world data regarding cycle times, crew needs, and equipment needs, except to the extent the complainant can show how it would avoid specific costs and delays. As

discussed above, and as we would explain in more detail in a rulemaking, even the best models significantly understate the costs and delays that railroads incur on a daily basis because of random adverse events. Real-world data is a practical alternative to modeling when a SARR purports to handle a large portion of the defendant carrier's traffic on any one line (or when the SARR is required to handle that traffic under a common carrier obligation). At the very least, we believe that the Board should require proponents of an operating plan based on a model to explain how their model accounts for such events and address the resources they have allocated to recover from disruptions.

We also have several preliminary suggestions for changing the SAC methodology to reflect unavoidable constraints on a defendant carrier's cost structure. For example, we believe that a SARR should have a common carrier obligation with respect to non-exempt traffic, just as a defendant carrier does, and just as any actual new entrant would. SARRs should not be allowed to avoid the significant costs that all defendant carriers must bear in order to implement operating plans that fulfill their common carrier obligations. A defendant carrier cannot hope to achieve revenue adequacy if it is required to set rates equal to those that a railroad could charge if it did not have a common carrier obligation.

As a final example, we believe that the Board should place the burden on a SARR to explain and document the source of its efficiencies when it purports to be substantially more efficient than the incumbent. Unless a SARR identifies a specific technology, asset, or other technique or resource that will make it substantially more efficient than the defendant carrier, it should have the same basic cost structure as the defendant carrier.

D. Other Issues.

UP believes that a rulemaking is the most appropriate forum in which to address other issues related to the SAC methodology that have surfaced in recent rate cases and that may

be raised by other participants in this hearing. For example, we expect that some parties in this hearing will comment on the percentage reduction method of establishing a rate prescription. We believe that any rate prescription methodology should reflect Ramsey pricing – that is, less elastic customers should be expected to pay differentially higher prices. The percentage reduction method is a practical approach that is consistent with Ramsey pricing, and we would want to analyze and comment upon any alternatives proposed by other parties.

We also expect that some parties in this hearing will comment on whether SARR operating expenses should be indexed using RCAF-U or RCAF-A. We believe that the Board has struck the right balance by using RCAF-U, given the efficiencies and productivity assumed in selecting traffic for, constructing, and operating a SARR. We would certainly want to analyze and comment upon any proposals to depart from established precedent.

Finally, we expect that parties in this hearing will comment on the potential interactions among various proposals. Concerns associated with the percentage reduction method arise in part because apparent SARR "over-recoveries" stem from large volumes of cross-over traffic rather than dollars earned handling the issue traffic itself. Concerns associated with the use of RCAF-A arise in part because SARRs are constructed to be ultra-efficient railroads from the start. Everybody will benefit from the type of careful scrutiny of these issues and interrelationships that a formal rulemaking can provide.

IV. FUTURE PROCEEDINGS

A public hearing in which interested parties have an opportunity to express their views is an important step in evaluating the SAC methodology, but the Board must go further. The SAC methodology is due for a reexamination in which all parties that have a stake in the methodology are afforded a meaningful opportunity to address and engage in a probing debate of these issues of great importance. Suggestions for change will require careful analysis, and the

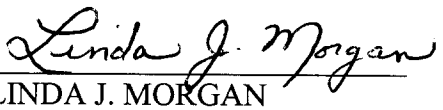
final outcome of this process will almost certainly be better if it is reached through a process that creates a dialogue among interested parties.

After this public hearing is complete, the Board should institute a multi-stage rulemaking proceeding to modify the SAC methodology. The Board should use the information obtained at this hearing and its experience in rate cases to issue an advance notice of proposed rulemaking seeking more detailed comments on issues of concern as well as concrete proposals for modifications to the SAC methodology. All interested parties should be given an opportunity to digest those comments and proposals, offer responsive evidence directed to them, and provide rebuttal in support of such proposals. When that initial phase of the proceeding is complete, the Board should issue its own proposals in a notice of proposed rulemaking and give interested parties the opportunity to submit comments, replies, and rebuttal.

A rulemaking is the most efficient process for obtaining the wide variety of perspectives needed to assess adequately revisions to the SAC methodology. The case-by-case approach followed thus far has resulted in a patchwork of rules that are producing results at odds with reality and the national transportation policy. A formal rulemaking is the most appropriate setting in which to conduct a broad review of SAC issues and develop new rules that are likely to remain in place for another twenty years.

Respectfully submitted,

J. MICHAEL HEMMER
LOUISE A. RINN
Union Pacific Railroad Company
1400 Douglas Street
Omaha, Nebraska 68179
Tel: (402) 544-5000



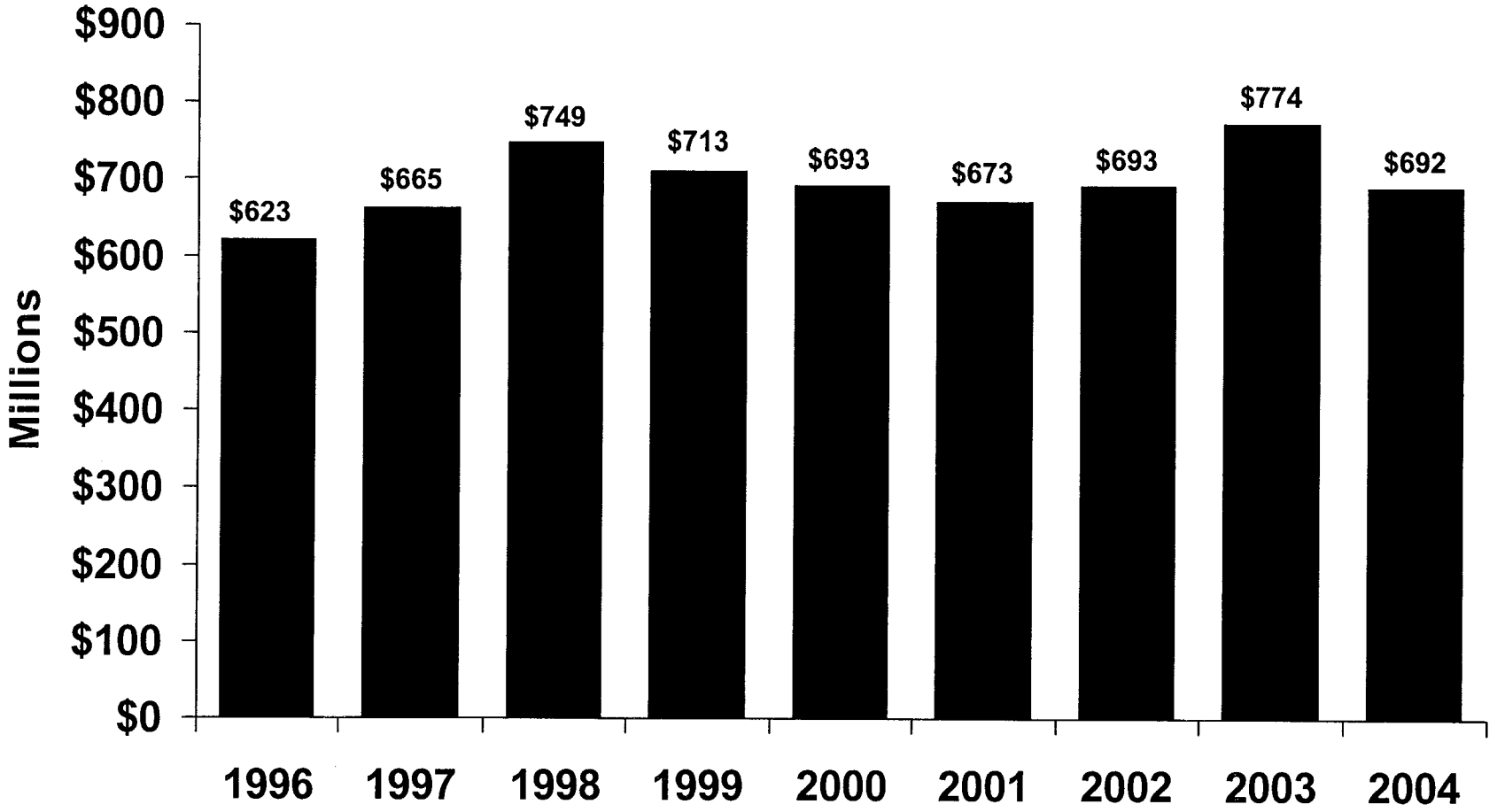
LINDA J. MORGAN
DAVID L. MEYER
MICHAEL L. ROSENTHAL
Covington & Burling
1201 Pennsylvania Ave., N.W.
Washington, D.C. 20004
Tel: (202) 662-6000
Fax: (202) 662-6291

Attorneys for Union Pacific Railroad Company

April 20, 2005

EXHIBIT 1

UP Investment in Energy Business
(MOW, Locomotives, Capacity and Coal Cars)



Notes:

1) Locomotive spending reflects cash and capital leases; includes locomotive facilities and other spending
2) MOW and locomotive amounts are based on revenue ton-mile allocation
3) Coal car spending reflects cash and capital leases

EXHIBIT 2

UP Revenue Shortfall - 1996 through 2004

(Dollar amounts in thousands)

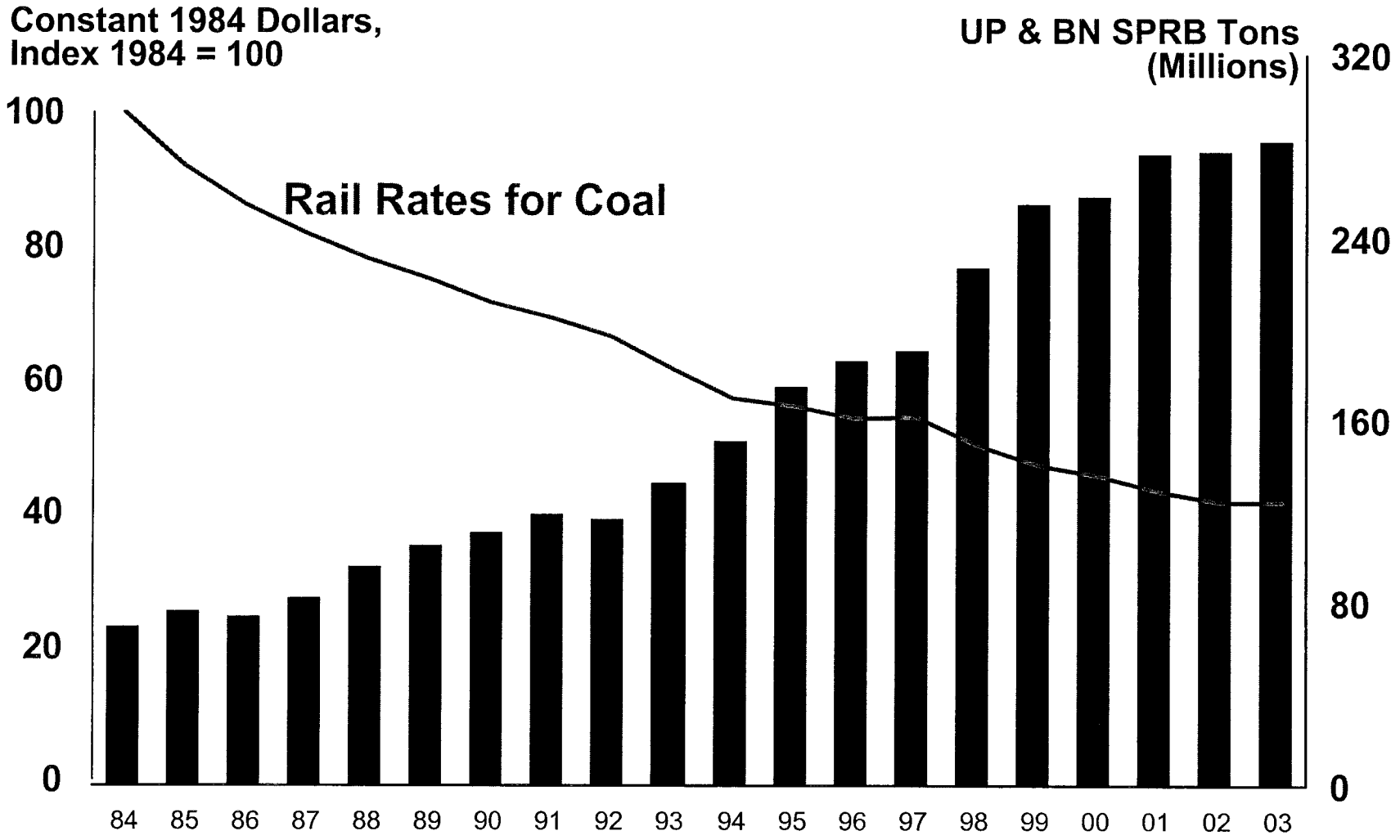
			1996 a/ b/	1997 a/ c/	1998 a/	1999 a/	2000 a/	2001 a/	2002 a/	2003 a/	2004 a/
	Net Investment Base										
1	January 1		$14,442,829	$18,056,445	$18,684,673	$19,716,311	$19,828,360	$19,677,299	$19,838,332	$20,274,354	$21,016,534
2	December 31		$14,909,362	$18,683,557	$19,716,311	$19,828,360	$20,089,271	$19,859,780	$20,274,354	$20,826,633	$21,516,704
3	Average		$14,676,096	$18,370,001	$19,200,492	$19,772,336	$19,958,816	$19,768,540	$20,056,343	$20,550,494	$21,266,619
4	Actual Net Railway Operating Income		$1,214,905	$959,979	$565,395	$1,347,977	$1,384,117	$1,508,262	$1,732,201	$1,492,593	$964,776
4a	WPL Adj. Net Railway Operating Income:	EWRR Revenue d/					$933,178	$1,009,937	$1,046,855	$1,063,848	$1,083,435
		SAC Rate Reduction e/					14.4%	25.3%	25.4%	25.1%	24.6%
		SAC Revenue Reduction					$134,378	$255,514	$265,901	$267,026	$266,525
		Tax @ 35%					($47,032)	($89,430)	($93,065)	($93,459)	($93,284)
		ATAX Rev. Reduction					$87,345	$166,084	$172,836	$173,567	$173,241
		Actual NROI	$1,214,905	$959,979	$565,395	$1,347,977	$1,384,117	$1,508,262	$1,732,201	$1,492,593	$964,776
		ATAX Rev. Reduction	$0	$0	$0	$0	($87,345)	($166,084)	($172,836)	($173,567)	($173,241)
		WPL Adj. NROI	$1,214,905	$959,979	$565,395	$1,347,977	$1,296,772	$1,342,178	$1,559,365	$1,319,026	$791,535
5	Annual Cost of Capital		11.9%	11.8%	10.7%	10.8%	11.0%	10.2%	9.8%	9.4%	10.1% f/
6	Target Net Railway Operating Income		$1,746,455	$2,167,660	$2,054,453	$2,135,412	$2,195,470	$2,016,391	$1,965,522	$1,931,746	$2,147,929
7	Actual Shortfall		($531,550)	($1,207,681)	($1,489,058)	($787,435)	($811,353)	($508,129)	($233,321)	($439,153)	($1,183,153)
7a	WPL Adj. Shortfall		N/A	N/A	N/A	N/A	($898,698)	($674,213)	($406,156)	($612,720)	($1,356,394)
8	Cumulative Shortfall		($531,550)	($1,739,231)	($3,228,289)	($4,015,724)	($4,827,077)	($5,335,206)	($5,568,527)	($6,007,680)	($7,190,833)
8a	WPL Adj. Cumulative Shortfall		N/A	N/A	N/A	N/A	($4,914,423)	($5,588,636)	($5,994,792)	($6,607,512)	($7,963,906)

a/ Schedule 250 data as filed by UPRR.
b/ Includes SP on a combined basis (no purchase accounting).
c/ Includes SP on a consolidated basis (purchase accounting).
d/ Docket 42051 WPL v. UP served 9/13/01 at 24 Table 2.
e/ Id. Served 5/14/02 Revised Table 3 "SAC Rate Reduction."
f/ As calculated by AAR in Ex Parte No. 558 (Sub-No. 8).

Note: Schedule 250 is a supplemental schedule filed approximately 30 days after the R-1; therefore it is not bound in the R-1 report.

Rail Coal Rates & PRB Volume

EXHIBIT 3



Rail rates for coal = revenue per ton-mile
Source: STB Waybill Sample